

Patent development and management service fees deducted from royalties collected from licensees by an exempt charitable organization for distribution to the beneficial owners of the patents is not within the exception for royalties provided by section 512(b) of the Code in determining 'unrelated business taxable income.'

Advice has been requested whether, in the situation described below, income derived by an organization subject to the provisions of section 511 of the Internal Revenue Code of 1954 constitutes royalty income excluded in computing unrelated business taxable income as defined in section 512 of the Code.

The organization is exempt from Federal income tax as a charitable organization under section 501(c)(3) of the Code. Its resources are dedicated to the advancement of science and its principal activity in that regard is providing financial support, in the form of grants, for scientific research. The organization disclaims all rights to patentable ideas that might be produced from research under its grants, but requires that the results of all research under its sponsorship be published and that the organization's financial support of the research be acknowledged.

In addition to its charitable activities, the organization evaluates, processes, promotes, develops, and manages the inventions of faculty members, associates, and staff members of educational and scientific institutions. The organization enters into agreements with the educational and scientific institutions under which it performs these services on condition that the faculty members, associates, and staff members assign title to their inventions to the organization. Pursuant to the agreements, the organization promotes the inventions it accepts title to by obtaining patents, introducing the patents to public use, and negotiating licenses with industrial firms. Upon termination of the agreements, the inventions received by the organization are assigned to the institutions but subject to any contracts that the organization may have entered into with the inventors and subject, also, to any licenses, grants, working rights, agreements, or other contracts made by the organization with respect to such inventions.

Under the terms of the agreements, the organization collects the royalty income from the licensees, retains a stated portion thereof as compensation for patent development and management services rendered, and distributes the remainder of the amounts collected to the institutions and the inventors in the proportions specified. The organization pays all the normal expenses involved in the patent management operation including the cost of preparing, filing, and prosecuting patent applications. It is further provided in each agreement that the organization shall maintain books, records, ledgers, and accounts relating to its activities thereunder and that it shall report

annually to the institution involved in such activities and provide the computation of payments thereunder.

Section 512(a) of the Code provides that the term 'unrelated business taxable income' means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b). Section 512(b)(2) of the Code provides that in determining unrelated business taxable income there shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

Section 1.512(b)-1 of the Income Tax Regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed 'rent' by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the exception for rent.

In this case the organization holds bare legal title to the inventions only for the purpose of performing the agreed patent development and management services for the account of the beneficial owners, i.e., the educational and scientific institutions and the inventors on their staffs. Thus, the royalties paid by the licensees of the patents are collected by the organization for distribution to such institutions and inventors in the proportions specified in the agreement. The organization is entitled to retain for itself only an agreed amount in payment for services rendered.

Therefore, although the amounts paid to the organization are derived from royalties, they do not retain the character of royalties in the organization's hands for the purposes of section 512(b) of the Code. Accordingly, it is held that the income realized by the organization is not within the exception for royalty income provided by section 512(b).